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The English reformulation of the penalty rule: Relevance in Singapore?

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Case Note

ENGLISH REFORMULATION OF THE PENALTY RULE

Relevance in Singapore?

Cavendish Square Holding BV v Makdessi
ParkingEye Ltd v Beavis
[2016] AC 1172; [2015] 3 WLR 1373

English law on the rule against penalty clauses ("penalty rule") has had a stable if unsatisfactory formulation for a while. The courts have long distinguished between liquidated damages and a penalty, on the basis that the former is a genuine pre-estimate of loss and that the latter is an unjustifiable tool used to coerce the performance of a contract. These long-standing principles have now to be re-evaluated in the light of the much-anticipated joint appeals of *Cavendish Square Holding BV v Makdessi* and *ParkingEye Ltd v Beavis* (collectively "*Cavendish*"). The purpose of this case note is to discuss *Cavendish* and evaluate the impact it might have on Singapore law. The immediate task for English law is to fully work out the basis and principles of the new rule in *Cavendish*. The impact on Singapore law will depend on how that pans out.

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I. Introduction

1 English law on the rule against penalty clauses ("penalty rule") has had a stable if unsatisfactory formulation for a while. The courts have long distinguished between liquidated damages and a penalty, on the basis that the former is a genuine pre-estimate of loss and that the latter is an unjustifiable tool used to coerce the performance of a contract. Liquidated damages are upheld not only because they embody the intentions of the contracting parties, but because they also save the

court and parties the time and expenses in ascertaining the exact loss suffered by the plaintiff. For years, the governing case that laid down the distinction between liquidated damages and a penalty is the English case of *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd*[1] ("*Dunlop Pneumatic*"). In that case, Lord Dunedin had laid down the following fundamental propositions:[2]

> 1. Though the parties to the contract who use the words 'penalty' or 'liquidated damages' may prima facie be supposed to mean what they say, yet the expression used is not conclusive. The Court must find out whether the payment stipulated is in truth a penalty or liquidated damages. …
>
> 2. The essence of a penalty is a payment of money stipulated as in terrorem of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damage …
>
> 3. The question whether a sum stipulated is penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged of as at the time of the making of the contract, not as at the time of breach …
>
> 4. To assist this task of construction various tests have been suggested … Such are:
>
> > (a) It will be held to be a penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach.
> >
> > (b) It will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid … [this is] truly a corollary to the last test. …
> >
> > (c) There is a presumption (but no more) that it is penalty when 'a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage' …[3]
> >
> > On the other hand:
> >
> > (d) It is no obstacle to the sum stipulated being a genuine pre-estimate of damage, that the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the situation when

1 [1915] AC 79.

2 *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79 at 86–88.

3 Citing Lord Watson in *Lord Elphinstone v Monkland Iron & Coal Co* (1886) 11 App Cas 332.

> it is probable that pre-estimated damage was the true bargain between the parties ….

Many have treated Lord Dunedin's second proposition in *Dunlop Pneumatic* as "an exhaustive dichotomy",[4] thereby focusing the analysis on whether the disputed clause was a "genuine pre-estimate" of the claimant's loss.

2 The Singapore position has followed the English position taken in *Dunlop Pneumatic* for a long time. Thus, in the recent High Court decision of *iTronic Holdings Pte Ltd v Tan Swee Leon* ("*iTronic Holdings*"),[5] George Wei J confined himself to the *Dunlop Pneumatic* principles. This was done either on the basis that the *Dunlop Pneumatic* principles are "said to be adequate and applicable in cases involving straightforward damages clauses" or because the Court of Appeal had in *Xia Zhengyan v Geng Changqing*[6] reaffirmed the applicability of those principles in Singapore law.[7]

3 These long-standing principles have now to be re-evaluated in the light of the much-anticipated joint appeals of *Cavendish Square Holding BV v Makdessi* ("*Cavendish v Makdessi*") and *ParkingEye Ltd v Beavis*[8] ("*ParkingEye v Beavis*") (collectively "*Cavendish*"). In *Cavendish*, the UK Supreme Court put forward a reformulation of the rule: a clause will be a penalty if it relates to a secondary obligation which effect is out of all proportion to the legitimate interest sought to be safeguarded by the provision. While Wei J in *iTronic Holdings* acknowledged the pending importance of *Cavendish*, he did not apply it, preferring to apply the traditional *Dunlop Pneumatic* principles. Subsequently, in the High Court case of *Allplus Holdings Pte Ltd v Phoon Wui Nyen*[9] ("*Allplus Holdings*"), Foo Tuat Yien JC applied the distinction drawn in *Cavendish* between primary and secondary obligations, marking the first time that a Singapore court had applied the new rules introduced by the case. The purpose of this case note is to discuss *Cavendish* and evaluate the impact it might have on Singapore law. The immediate task for English law is to fully work out the basis and principles of the new rule in *Cavendish*. The impact on Singapore law will depend on how that pans out. Before discussing the consequences of *Cavendish* on English and Singapore law, let us first consider the background facts of the joint appeals in *Cavendish*.

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4 *Chitty on Contracts* (H Beale ed) (London: Sweet & Maxwell, 32nd Ed, 2015) at para 26-182.
5 [2016] 3 SLR 663.
6 [2015] 3 SLR 732.
7 *iTronic Holdings Pte Ltd v Tan Swee Leon* [2016] 3 SLR 663 at [175].
8 [2016] AC 1172; [2015] 3 WLR 1373 at [116].
9 [2016] SGHC 144.

II. Background facts

A. Cavendish v Makdessi

4 In the *Cavendish v Makdessi* appeal, Makdessi was the founder of the largest advertising and marketing communications group in the Middle East ("the Group"). By an agreement on 28 February 2008, he and a partner agreed to sell their controlling stake in the Group's holding company ("the Company") to Cavendish. Consequently, Cavendish held 60% of the Company while Makdessi and his partner retained 40%.

5 As was typical of acquisition agreements in the marketing sector, a proportion of the purchase price represented goodwill. To safeguard Cavendish's interests, cl 11.2 provided that Makdessi shall not, until two years after he ceased to hold any shares in the Company or the date of any final payment, (a) provide, solicit or accept enquiries/orders for goods or services which competed with the Group companies in countries in which any of the Group companies carried on businesses; (b) divert orders, enquiries or business from any Group company, or (c) employ or solicit any senior employee or consultant of any Group company.

6 Significantly, breach of cl 11 and other obligations under the contract by Makdessi and his partner would result in the variation of Cavendish's payment of the purchase price. Had there been no breach, Cavendish was to pay US$34m upon the completion of the transaction. It was then to pay a further US$31.5m into escrow, to be paid out over a period of time. It was also to pay an "interim payment" and "final payment" 30 days after agreement of the Group's operating profits for 2007–2009 and 2007–2011 respectively. On the other hand, if Makdessi was in breach of cl 11.2, cl 5.1 provided that Makdessi shall lose his entitlement to receive the interim payment and/or the final payment. Further, pursuant to cl 5.6, Cavendish would have an option to require Makdessi to sell all his remaining shares in the Company to Cavendish at a certain price that excluded the value of the goodwill of the business.

7 Makdessi defended against Cavendish's invocation of cll 5.1 and 5.6 on the basis that these clauses were penalty provisions and therefore unenforceable. At first instance, Burton J held that the clauses were valid and enforceable,[10] but the Court of Appeal found to the contrary.[11] On appeal, the Supreme Court unanimously overturned the Court of Appeal's ruling.

10 *Cavendish Square Holding BV v Talal El Makdessi* [2012] EWHC 3582 (Comm).
11 *Talal El Makdessi v Cavendish Square Holding BV* [2013] EWCA Civ 1539.

B. ParkingEye v Beavis

8 In the second appeal, ParkingEye Ltd managed a car park in a retail park owned by the British Airways Pension Fund. ParkingEye displayed about 20 large, prominent and legible signs at the entrance of and throughout the car park so that any reasonable user would have a fair opportunity to read them. 80% of these signs informed that ParkingEye had been "solely engaged to provide a traffic space maximisation scheme" – users would be limited to a free two-hour maximum stay in the car park and a "Parking Charge" of £85 would be imposed against any user who overstayed.

9 Beavis overstayed by nearly an hour and received a "first parking charge notice" from ParkingEye. The notice demanded payment of £85 within 28 days but also stated that, if Beavis should pay within 14 days, the sum would be reduced to £50. Beavis ignored this notice, as well as a subsequent reminder notice and warning letter. ParkingEye then sued Beavis in the County Court to recover the £85. The main issue was whether the charge was unenforceable as a penalty, or unfair and thus unenforceable under the Unfair Terms in Consumer Contracts Regulations 1999. Both the Court of Appeal and the judge at first instance found for ParkingEye. Beavis therefore appealed to the Supreme Court.

III. New penalty rule

10 The two appeals presented a ripe opportunity for the Supreme Court to consider afresh the contemporary relevance and operation of the penalty rule. In fact, as Lord Mance put it, the two cases occupied "opposite ends of a financial spectrum", thereby affording the Supreme Court a clear overview of the pertinent issues.[12] It was unanimously agreed that the penalty rule should not be abolished, owing to its vintage, continued relevance in all major legal systems,[13] as well as utility in regulating contracts/businesses that are not presently protected by legislation.[14] Moreover, its retention in English law is consistent with other well-established principles such as relief from forfeiture, the equity

12 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [116].

13 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [37] (*per* Lords Neuberger and Sumption), [162]–[167] (*per* Lord Mance) and [263] (*per* Lord Hodge).

14 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [38] (*per* Lords Neuberger and Sumption), [167] (*per* Lord Mance) and [260] (*per* Lord Hodge).

of redemption and the refusal to grant specific performance.[15] Nor did their Lordships see any basis for extending the penalty rule to cover clauses triggered other than by breach of contract, thus refusing to adopt the Australian approach taken in *Andrews v Australian and New Zealand Banking Group Ltd*[16] ("*Andrews*"). It was thought that an extension of the doctrine behoves legislative intervention.[17] Lord Mance also explicitly rejected restricting the doctrine such that it does not apply in "commercial cases".[18] Apart from there being no basis in authority or principle for doing so, it would also remove protection afforded by the doctrine in an area where it is frequently invoked. Importantly, what amounts to a "commercial case" is difficult to define. Similarly finding the proposal unattractive, Lord Hodge pointed out that restricting the doctrine to non-commercial cases will likely increase litigation costs spent on disputing issues of fact concerning the relative bargaining positions of the parties and the competence of their lawyers.[19]

11 Although their Lordships neither abolished nor restricted the application of the penalty rule, they agreed that it is in need of reformulation for clarity and focused application. The restated rule focuses on whether the contract provision relates to a secondary obligation which effect is entirely disproportionate to the legitimate interest protected. Although not new, this re-emphasis on the primary/secondary obligation distinction is of importance. The reformulation has three essential elements. First, the provision must relate to a secondary obligation, as opposed to a primary obligation, for it to be caught by the penalty rule. Secondly, the court will determine what the innocent party's legitimate interest is. Thirdly, in order for a clause to be struck down as a penalty, its effect must be out of all proportion to the legitimate interest that is sought to be protected. Indeed, some of the judges had used the expression "extravagant,

15 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [39].

16 (2012) 247 CLR 205, noted in J W Carter, W Courtney, E Peden, A Stewart & G J Tolhurst, "Contractual Penalties: Resurrecting the Equitable Jurisdiction" (2013) 30 JCL 99; R Manly, "Breach No Longer Necessary: The High Court's Reconsideration of the Penalty Doctrine" (2013) 41 *Australian Business Law Review* 314 and S Harder, "The Relevance of Breach to the Applicability of the Rule Against Penalties" (2013) 30 JCL 52.

17 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [43].

18 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [168].

19 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [267].

unconscionable and extortionate" to express this idea.[20] Each of these points requires fuller elaboration.

12 First and foremost, the application of this rule depends on a distinction drawn between a primary obligation and a secondary obligation; only the latter brings the rule into play.[21] Other than the classical example of a secondary obligation to pay a sum of money upon a breach of contract,[22] an obligation to transfer assets either for nothing or at undervalue, as well as a sum paid over to another party as a deposit could also be construed as secondary obligations.[23] On the other hand, a conditional primary obligation, which may provide for the payment of a sum of money if the other party fails to perform an act, does not attract the penalty rule.[24]

13 Secondly, Lords Neuberger, Sumption and Carnwath clarified that Lord Dunedin's four tests in *Dunlop Pneumatic* are not rules but considerations that indicated whether a clause is an unenforceable penalty.[25] The true test of "penalty" is not dependent upon whether the clause prescribes for a genuine pre-estimate of the loss or whether its purpose is deterrence; these are "not natural opposites or mutually exclusive categories".[26] Instead, its essence lies in evaluating whether the effect of the secondary obligation is clearly *excessive in relation* to the innocent party's *legitimate interest*, even if their Lordships each used slightly different terminology.[27] "Penalty" is thus not prescribed as an absolute standard. Their Lordships also stressed that there can be no proper interest in simply punishing the defaulting party.[28]

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20 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [181], [255] and [293].

21 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [12] (*per* Lords Neuberger and Sumption).

22 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [16].

23 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [16].

24 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [14].

25 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [22].

26 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [31] (*per* Lords Neuberger and Sumption), [225] and [248] (*per* Lord Hodge).

27 See, *eg*, *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [22] (*per* Lords Neuberger and Sumption), [154] (*per* Lord Mance) and [221] (*per* Lord Hodge).

28 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [32].

14 Finally, some factors that are relevant to determining whether the innocent party's legitimate interest justifies the protection prescribed include circumstances in which the contract was made.[29] Where the contract was concluded between parties of comparable bargaining power and both of whom were legally advised, Lords Neuberger, Sumption and Carnworth said that there is a "strong initial presumption" that the parties are aware of the consequences of the penalty clause, which implies that it should be upheld.[30]

IV. Application of reformulated penalty rule

A. Cavendish v Makdessi

15 Whilst all the members of the Supreme Court applied the same test to cll 5.1 and 5.6 and agreed that they were valid and enforceable, their Lordships' analyses differed somewhat. The disagreement is particularly evident in respect of the threshold issue of whether the clauses related to secondary obligations. Lords Neuberger, Sumption and Carnwath found that cll 5.1 and 5.6 were provisions of primary obligations. They characterised cl 5.1 as a price adjustment clause that affected the consideration earned by Makdessi and his partner under the contract. Clause 5.1 implemented this by imposing a substantial delayed payment to protect the goodwill of the business.[31] Their Lordships also concluded that cl 5.6, in conferring an option to acquire the shares, related to a primary obligation even if it only becomes relevant upon a breach of contract.[32] Clause 5.6 similarly reflected the reduced price that Cavendish was prepared to pay for the shares in the event of Makdessi's disloyalty.[33] On this analysis, the penalty rule would not even apply.

16 On the other hand, Lord Mance, in his analysis of cll 5.1 and 5.6, focused on whether Cavendish had a legitimate interest that justified their imposition. This therefore assumed that the provisions were secondary obligations.[34] Indeed, in respect of cl 5.1, Lord Mance rejected Cavendish's argument that it was in substance a price formula

29 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [35].

30 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [35]; see also [152] (*per* Lord Mance).

31 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [74] and [77].

32 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [83].

33 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [81].

34 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [171]–[181] and [182]–[186].

founded on the provision in cl 3.1 that the agreed payments were in consideration of the shares and the sellers' obligations. [35] Somewhat equivocally, however, Lord Mance acknowledged that cl 5.6 redefined the parties' "primary relationship".[36]

17 In contrast, Lord Hodge expressly construed cl 5.6 as a secondary obligation designed to deter the sellers from breaching their obligations under cl 11.2.[37] Yet, in respect of cl 5.1, his Lordship's analysis was a little more obscure. While acknowledging that there was a "strong argument" that cl 5.1 was in substance a primary obligation, his Lordship analysed cl 5.1 on the assumption that it was a secondary obligation caught by the penalty rule.[38]

18 Without appreciating the distinctions in analyses, Lord Toulson stated his agreement with Lords Mance and Hodge in *Cavendish*.[39] Even more confusingly, Lord Clarke agreed with the reasoning of Lords Neuberger, Sumption, Mance and Hodge.[40] Whether a clear majority was ultimately reached on the nature of the obligations prescribed under cll 5.1 and 5.6 is therefore unclear.

19 Lords Neuberger, Sumption and Carnwath considered that, even if cl 5.1 defined the parties' secondary obligations, Cavendish had a legitimate interest in Makdessi's observance of the restrictive covenants insofar as the goodwill of the business was concerned.[41] It was immaterial that it had no relationship with the measure of loss attributable to breach. Also, that cl 5.6 had a deterrent effect was not the point since Cavendish had a legitimate interest "in matching the price of the retained shares to the value that the [s]ellers were contributing to the business".[42] It was commercially sensible that Cavendish should not pay for goodwill where the defaulting shareholders were no longer

35 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [179].
36 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [183].
37 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [280].
38 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [270] and the analysis from [271]–[278].
39 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [292].
40 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [291].
41 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [75].
42 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [82].

contributing to the goodwill of the Company or were actively reducing it.[43]

20 Lord Mance emphasised that the proper approach is to focus on the overall purpose of the covenants, rather than on the individual breaches.[44] By this approach, Lord Mance concluded that cll 5.1 and 5.6 were concerned with the damage from competitive activity. Applying Lord Parker's analysis in *Dunlop Pneumatic*, there was accordingly no penal presumption against cll 5.1 and 5.6.[45] Furthermore, Lord Mance said that cl 5.1 was part of a carefully negotiated agreement between informed and legally advised parties who were conscious of the importance of the Group's goodwill to Cavendish.[46] As for cl 5.6, Lord Mance regarded the essential question as this: whether it can be regarded as "exorbitant or unconscionable" once Makdessi had breached the restrictive covenants and affected the goodwill of the Group.[47] His Lordship was of the view that cl 5.6 was a "natural provision" to include as a consequence of breach that affected the goodwill of the Group, which in turn necessitated the complete severance of relationships between the parties.[48]

21 Lord Hodge paid particular emphasis on the fact that the parties had attributed a high value to the goodwill of the Group and this was reflected in the consideration paid.[49] Lord Hodge considered as "unrealistic" that cl 5.1 could be triggered by a minor breach of cl 11.2 since cl 5.1 was aimed at addressing the disloyalty of a seller who attacked the company's goodwill.[50] It follows that cl 5.1 was entirely commensurate with Cavendish's legitimate interests.[51] As for cl 5.6, while noting that the defaulting shareholder option price was harsh, Lord Hodge held that it was not exorbitant because goodwill was critical

43 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [82].
44 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [172].
45 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [173]–[174].
46 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [180]–[181].
47 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [185].
48 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [185].
49 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [271]–[272].
50 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [275].
51 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [278].

for the success of the sale in (especially) the Middle Eastern context.[52] Clause 5.6 was also not unconscionable as it was part of a contract that was negotiated in detail by parties who were of relatively equal bargaining power and legally advised.[53]

B. ParkingEye v Beavis

22 The Supreme Court unanimously agreed that the clause in *ParkingEye v Beavis* concerned a secondary obligation, and was therefore subject to the penalty rule. Lords Neuberger, Sumption and Carnwath explained that the parking charge could not be characterised as consideration for parking (and therefore a primary obligation) because it was imposed for breaches other than overstaying and importantly, it was not imposed based on a time period for which the motorists could stay after the initial two hours of free parking.[54]

23 However, the fact that ParkingEye suffered no loss by the motorists' overstaying at the car park due to it not having proprietary interest in the property did not render the contractual provision penal.[55] The motorists would not care whether it was the landowner or ParkingEye who operated the parking scheme. Importantly, it was held that ParkingEye had a legitimate interest to protect. The legitimate interest arose out of the outsourcing arrangement between the landowner and ParkingEye: ParkingEye provided a valuable service of maximising the use of car park spaces which benefited the landowner, retailers operating on site and their customers, and this service was funded by charges paid by the car park overstayers.[56]

24 The more difficult question is whether ParkingEye's legitimate interest justified the imposition of the £85 charge. It was held that it was not excessive to constitute a penalty. In coming to their conclusion, Lords Neuberger, Sumption, Carnwath, Mance and Hodge placed considerable weight on the fact that the scheme was transparent because

52 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [282].

53 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [282].

54 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [94]. Lord Mance (at [130]) acknowledged that ParkingEye could have economic reasons (*eg*, tax issues) for formulating the clause as an obligation arising upon breach.

55 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [99].

56 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [99] (*per* Lords Neuberger and Sumption), [197] (*per* Lord Mance) and [287] (*per* Lord Hodge).

incoming motorists were amply informed by the prominent signs on the risk of incurring the £85 charge.[57] Lords Neuberger, Sumption, Carnwath and Hodge also considered that £85 was below the maximum amount prescribed by the British Parking Association in relation to charges for public car parks beyond which justification would be required. Lord Mance gave other reasons. He found that £85 was not so high a sum that no ordinary customer would wish to incur.[58] He further said that the charge was justified by the fact that ParkingEye, a specialist contractor in this case, had to make a profit from the endeavour.

25 Although it does not apply in Singapore, for completeness, it should be noted that Lord Toulson dissented from the majority view that the £85 charge was not unfair under the Unfair Terms in Consumer Contracts Regulations 1999, an issue that required an inquiry into the relationship between regulation and the penalty rule. This commentary only focuses on the common law doctrine of penalty.

V. Some reflections on the penalty rule

A. Basis of the penalty rule

26 The Supreme Court's decision also raises several points for reflection. First of all, it establishes that the doctrine is not against penalties in contracts *per se*. Instead, the rule is firmly established in the public policy of regulating contractual relationships between parties of unequal bargaining power, especially relationships that are not presently protected by consumer regulations or the Unfair Contract Terms Act 1977.[59] More precisely, it is a limited form of common law protection of parties in weaker bargaining positions from being forced to agree to manifestly disadvantageous and oppressive terms. The protection is, however, limited in two principal ways. First, it only attacks secondary obligations. Parties are free to agree to onerous primary obligations. As such, the reformulated penalty rule affirms the centrality of the compensatory principle for breach of contract – proper justification is required for the innocent party to be entitled to more than compensation. Secondly, the reformulated rule integrates a balancing exercise between the innocent party's legitimate interest and unfairness to the breaching party. Implicit in the balancing exercise is also the recognition that compensation for breach of contract is not always

57 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [100] (*per* Lords Neuberger and Sumption), [198] (*per* Lord Mance) and [287] (*per* Lord Hodge).

58 *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [198].

59 c 50 (UK).

sufficient. Indeed, the actual performance of the primary obligations by one party may be significant for the other party when taking a wider view of the latter's interests. English contract law protects this interest not by granting specific performance liberally, but by allowing parties the liberty to prescribe the primary obligations in their agreement and a modicum of freedom in providing for non-compensatory consequences upon breach of the primary obligations where the circumstances of the case so justify. The reformulated rule is thus consistent with the principle of party autonomy, a central tenet of English contract law.[60]

27 More specifically, if, after *Cavendish*, it is understood that the English penalty rule is not against "penalties" that can otherwise be justified, there may be a need to reconsider the objection against awarding punitive damages for breach of a contract,[61] which is said to be justified by the penalty doctrine.[62] Could it be argued that the English courts should award punitive damages for breach of contract where the innocent party is able to demonstrate that it has legitimate interests that go beyond compensation? It may be that the *Cavendish* reformulation does not automatically lead to such an outcome. The refusal to award punitive damages for breach of contract is consistent with the English tradition of contract law. It is one thing to uphold party autonomy and quite another for contract law to prescribe a more expansive range of remedies from an *ex post* perspective.

28 Understanding the basis of the reformulated rule brings further illumination on the operation of the rule. It is to the elements of the rule which we now turn.

B. Distinction between "primary obligations" and "secondary obligations"

29 *Cavendish* reveals a genuine difficulty in distinguishing between primary obligations and secondary obligations in complex commercial transactions. Yet, this threshold issue is significant as it determines whether the penalty rule is brought into play in the first place. Modern commercial contracts often involve complex drafting prescribing a web of correlated clauses, rendering the distinction between primary and secondary obligations far less bright-line than expected. Indeed, it may be possible to avoid the penalty rule through careful drafting, which

60 *Cf* K Barnett, "Before the High Court: *Paciocco v Australia and New Zealand Banking Group Ltd: Are Late Payment Fees on Credit Cards Enforceable*" (2015) 37 Syd LR 595 at 605.

61 See, *eg*, *Addis v Gramophone Co Ltd* [1909] AC 488.

62 S Rowan, *Remedies for Breach of Contract: A Comparative Analysis of the Protection of Performance* (Oxford: Oxford University Press, 2012) at p 188.

may not be in line with the key substantive purpose behind the rule in the first place. Yet, there is a limit to good drafting, principally because the courts are always going to be concerned with substance over form. Moreover, parties may not wish to disclose fully their wider commercial interests for reasons of confidentiality obligations, competition and so forth.

30 The better view is that the "secondary obligation" prerequisite operates as a gatekeeping device to prevent excessive judicial interference with the parties' bargain. The crux of the rule probably lies in the posterior analysis of whether the effect of the clause is manifestly excessive or entirely out of proportion to the legitimate interest of the innocent party. Yet, sole reliance on the balancing exercise to limit judicial intervention is not entirely secure. Commercial parties can always point to a legitimate commercial interest and whether the effect of the contractual provision is excessive or exorbitant by reference to the commercial interest is ultimately a value judgment[63] – a judgment that may be difficult to make in less clear-cut cases. The "secondary obligation" prerequisite is a rigid but moderately effective way of reducing the scope of operation.

31 Underpinning the characterisation exercise is the query concerning the value of freedom of contract. Modern commerce cannot be understood on the paradigm case of a simple sale and purchase agreement – if we keep to such a model, the law will find modern drafting objectionable on the basis of simplistic and anachronistic understanding. After all, the court is not better placed than parties to determine the core interests of their transactions.

C. What is a legitimate interest?

32 Indeed, the requirement of a legitimate interest amounts to judicial recognition that parties are best placed to protect their own non-compensatory interests. This will especially be the case if the particular contract in dispute is merely part of a web of contracts or a wider transaction with far-reaching implications if that particular contract in dispute has been breached. This may explain why their Lordships said "legitimate interests" is to be determined by considering the transaction as a whole and one might have to look beyond that one contract into the wider background to understand fully its objectives and the commercial interests at stake.

63 See, *eg*, *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [249] (*per* Lord Hodge).

33 Whilst in many cases legitimate interests are commercial interests, their Lordships acknowledged that the concept is not so limited.[64] A sideways glance may be cast at the law of account of profits for breach of contract. An account of profits may be exceptionally awarded for breach of contract where the innocent party can demonstrate that it has a legitimate interest to protect, warranting the grant of a non-compensatory remedy. In the seminal case of *Attorney General v Blake*,[65] a double agent wrote a book about his secret services work and was sued by the Crown for the profits he made on the book. In this case, the normal remedy was insufficient to compensate for breach of contract, with the national security of ensuring that the secret service could operate in complete confidence being deemed a legitimate interest. There is no reason why a similarly non-commercial interest cannot amount to a legitimate interest justifying prescription of non-compensatory consequences for breach of contract.

D. Proportionality

34 Of course, that the innocent party has a legitimate interest to protect is insufficient – it must be further shown that the effect of the provision is not entirely excessive of the said interest. It is in essence a question of proportionality. Fairness and reasonableness are the overarching themes. Factors such as whether reasonable notice of the allegedly penal term has been given to the other party is therefore relevant, as can be seen in the *ParkingEye v Beavis* appeal. Or, as in the *Cavendish v Makdessi* appeal, whether the parties are of roughly equal bargaining power and have been legally advised in entering into the transaction; and whether the innocent party's "legitimate interest" has been made known to the other contracting party at the time of contracting.

35 The *ParkingEye v Beavis* appeal also shows that relevant statutory or industry guidelines may be drawn upon in measuring proportionality. In this connection, it may be that the same factors that are used to determine the reasonableness of an exemption clause under the Unfair Contract Terms Act and similar regulations[66] would also be

64 See, *eg*, *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [162] (*per* Lord Mance) and [256] (*per* Lord Hodge).

65 [2001] 1 AC 268.

66 For example, the Unfair Terms in Consumer Contracts Regulations 1999 (SI 1999/2083) – there was a separate issue in the *ParkingEye v Beavis* appeal as to whether the parking charge was in contravention of the said regulation. *Cf* Lord Toulson, in his lone dissent, expressed the view that the approach under the Regulations 1999 is not necessarily the same as in the approach under the

(*cont'd on the next page*)

highly relevant in determining the proportionality of a consequence to a legitimate interest. If so, there is already an established body of case law that the courts can use in relation to the penalty rule.

36 There remains one issue that requires judicial elucidation. The *Cavendish v Makdessi* appeal concerned two provisions in the contract which prescribed for separate consequences in the event that Makdessi became a "defaulting shareholder". Perhaps owing to the characterisation complexity discussed above, the Supreme Court did not consider[67] the issue whether provisions that prescribe for separate consequences in the event of the same breach could cumulatively be regarded as penal and unenforceable, even though each considered individually may not be penal. There is a case to be made that cumulative effect should be relevant under the penalty doctrine, especially where the innocent party seeks to enforce the relevant provisions together, thereby enhancing the harshness of the impact upon the party in breach. Otherwise, contracting parties may escape the penalty rule by setting out the consequences of breach in separate provisions.

VI. Impact on Singapore law

37 A limited effect of *Cavendish* can be observed in *iTronic Holdings*. Relying on the English ruling for illustration,[68] Wei J addressed the distinction between a primary obligation and a secondary obligation. Following Singapore precedents, Wei J had no reason to doubt that the distinction is part of Singapore law and the penalty rule only applies to secondary obligations.[69] In *iTronic Holdings*, the essence of the agreement between the parties is that the plaintiffs were to loan the defendant the sum specified. If the defendant succeeded in his attempt to list the company concerned, the plaintiffs could choose to convert the loans into $3m worth of shares. If the plaintiffs chose not to do that, they can ask for repayment of the principal sum and also additional sums, which were termed "compensation sums". The question was whether the "compensation sums" were a remedy for a breach of a primary obligation, which would make them a secondary obligation. Wei J held that they were not. The defendant's repayment obligation is really a conditional primary obligation. As such, the penalty rule does not apply.

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common law doctrine of penalty. See *Cavendish Square Holding BV v Makdessi; Parkingeye Ltd v Beavis* [2016] AC 1172; [2015] 3 WLR 1373 at [295]–[316].

67 Lord Mance came the closest to considering the issue when he addressed the effect of cl 5.6 and how the clause was necessary in an event of disloyalty to effect severance of the parties' relationship.

68 *iTronic Holdings Pte Ltd v Tan Swee Leon* [2016] 3 SLR 663 at [167].

69 *iTronic Holdings Pte Ltd v Tan Swee Leon* [2016] 3 SLR 663 at [165].

38 In *Allplus Holdings*, Foo JC also discussed the distinction between primary and secondary obligations. In her view, the distinction lies with whether "there was an obligation on a party to perform an act for which a failure to do so would trigger a further obligation to pay a specific sum of money".[70] If there was such an obligation, the obligation to pay the sum of money would be a secondary obligation that is subject to the penalty rule. On the facts of that case, because the impugned cl 4 stated the consequence of non-compliance with cl 1, it was in substance a secondary obligation that was subject to the penalty rule.

39 The Singapore courts' consideration of the primary and secondary obligation distinction cannot be faulted. Their emphasis on the need for these clauses to be evaluated substantively would deter parties from seeking to get around the penalty rule by clever drafting. Nevertheless, the true significance of the primary and secondary obligation distinction behoves a full review by the Singapore Court of Appeal. *Cavendish* has come at a time when the penalty rule is undergoing changes elsewhere in the common law world. The primary and secondary obligation distinction limits the scope of the English reformulated rule to strike at only clauses prescribing secondary obligations. It signals English preference for more tempered judicial interference with parties' freedom to contract. By contrast, in the High Court of Australia case of *Andrews*, the penalty rule was extended to cover situations other than breach of contract. *Andrews* has been widely criticised for increasing commercial risks by broadening the application of the penalty rule to a number of common contractual mechanisms that do not involve breach.[71] In the subsequent High Court of Australia case of *Paciocco v Australia and New Zealand Banking Group Ltd*[72] ("*Paciocco*"), the majority,[73] affirming the decision of the Full Court of the Federal Court below,[74] held that credit card late payment fees are not a penalty as long as they are not "out of all proportion" to the charging bank's interests. *Dunlop Pneumatic* and *Andrews* remain good law in Australia, although the *Paciocco* dispute did not concern the controversial extension in *Andrews*. Notably, French CJ emphasised that the "common law of Australia" has diverged from English developments and that convergence between the common law jurisdictions – desirable

70 *Allplus Holdings Pte Ltd v Phoon Wui Nyen* [2016] SGHC 144 at [19].

71 See, *eg*, J W Carter, W Courtney, E Peden, A Stewart & G J Tolhurst, "Contractual Penalties: Resurrecting the Equitable Jurisdiction" (2013) 30 JCL 99; R Manly, "Breach No Longer Necessary: The High Court's Reconsideration of the Penalty Doctrine" (2013) 41 *Australian Business Law Review* 314 and S Harder, "The Relevance of Breach to the Applicability of the Rule Against Penalties" (2013) 30 JCL 52.

72 [2016] HCA 28.

73 Comprising French CJ, Kiefel, Keane and Gageler JJ; Nettle J dissenting.

74 *Paciocco v Australia and New Zealand Banking Group Ltd* [2015] FCAFC 50.

in commercial law – may not be best brought about through the common law process.[75] *Paciocco* would provide guidance for the upcoming appeal of the New Zealand High Court's judgment in *Torchlight Fund No 1 LP v Johnstone*,[76] a case which applied New South Wales law and similarly involved a late payment fee clause.

40 In the final analysis, although the penalty rule was derived from *Dunlop Pneumatic*, the common law system requires lawyers in each generation to critically consider whether the principles that have been inherited remain sensible and adequate. Ultimately, the question is one of reform: what is the scope of operation of the penalty rule and the appropriate test to be applied? How Singapore law will choose and what its contribution to the ongoing debate remains to be seen. But any proposed alterations must be supported by principle and policy. To some extent, whether Singapore will join the company of English law will depend on the impact of *Cavendish* on English law and practice.

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75 *Paciocco v Australia and New Zealand Banking Group Ltd* [2016] HCA 28 at [9]–[10].

76 [2015] NZHC 25.